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Internal Auditing and its Role in Good Corporate Governance-A Case Study of Oriental Quarries

A Ananda Kumar[1], S Vignesh[2]
[1]*Research & Development-Head, DMI – St. Eugene University, Lusaka, Zambia.*
[2]*Lecturer, DMI – St. Eugene University, Lusaka, Zambia.*

Abstract

The study examines the level of corporate fraud in Zambia and assesses the impact of such fraud on the Zambian economy, corporate behavior, and ethics of the society, and evaluates the effectiveness of both internal audit and corporate governance as currently perceived and practiced in Zambia, particularly in Oriental Quarries. It explores and suggests more effective ways of enhancing internal audit and corporate governance systems as complementary, monitoring, and controlling devices to ensure high standards of corporate conduct. It discusses the internal audit function, role of the internal auditor, and the essentials for effective internal auditing; it explores the concept of corporate governance and its major developments; relevant emerging issues in auditing, the nature of fraud, its detrimental effects, and certain reasons for its occurrence. Data collection was achieved through questionnaires, interviews, observation, participation in seminars, and the study of documentary material from various sources. The dissertation concludes that fraud is more prevalent and highly sophisticated than is currently perceived. The internal audit function is generally weak, existing corporate governance arrangements are weak and inadequate, and that there is a serious lack of probity on the part of both management and employees. Recommendations to remedy the situation include the compulsory requirement for effective internal audit departments/service, ethics training, ethical codes, ethical advocates, whistleblowing. and the implementation of effective corporate governance systems, to ensure financial discipline, transparency, accountability, and to improve.

Keywords: Corporate governance, Economy, Ethical, Internal audit.

Introduction

Organizations are extremely important to all of us, this cannot be a subject of debate. "People are born and educated in organizations, acquire most of their material possessions from organizations, and die as members of organizations. And because organizations influence our lives so powerfully, we have every reason to be concerned about how and why those organizations function" (Moorhead/Griffin). The modern corporate form which has evolved from the advent of the industrial revolution has become the most efficient institution through which large scale commercial activity can be carried out. An organization, therefore, provides a co-ordinated system in which inputs obtained from the environment are transformed into outputs that are taken back into the environment.

As a result of this process, relationships beneficial to members of society develop. Some people become consumers while some become employees or investors. Employees receive wages/salaries. Investors receive a return on their funds and the government receives taxes and rates out of which public services such as health, education, and security are financed. The organization receives profit which is re-invested in new technology, new products, and thus new jobs. The result is a general increase in the living standards of the people. Proper and effective management is therefore crucial as it enhances the profitability and efficiency of companies and their capacity to create wealth and employment.

The occurrence of fraud seriously undermines the socio-economic development of a country and justifies the need to strengthen systems of good corporate governance. The combined effect of the full costs of fraud which include hidden costs, such as loss of business impetus, seriously impairs the financial well-being of the organization and places a significant drain on its profitability. Profit is important to business, which is about sustained wealth creation. Emphasizing on the importance of profit to a business, Hartley asserts that: “Profit in business is like food to a human body: The body must grow and develop - with the assistance of food; take away the supply of food and the body wastes and eventually dies”.

If providers of capital cannot earn an acceptable return on their funds, they will not invest, and there will be no growth in commercial and industrial activity. The level of employment and productivity will, therefore, decline and so will the living standards. Despite the availability of a variety of managerial tools of control and technical capacity necessary for maintaining and improving the standards of corporate conduct, the Zambian organizational settings have in recent years been characterized by unsound management practices and the emergence of unethical problems of varying degrees. The prevalence of corporate fraud in Zambia, the extent and frequency of which appear to have assumed alarming proportions, as evidenced by the research findings, has to be one problem of deep concern in so far as the financial wellbeing and viability of virtually any business enterprise or organization is concerned.

The ever-growing list of violations committed against organizations, by both management and employees, with or without the collusion of outsiders, reported in the electronic and print media, which by all accounts are just a hypothesis berg, gives cause for deep concern over the viability of business concerns and the quality of corporate management. For instance, Lyons Ltd. of Ndola was in August 1998 temporarily closed down due to what management termed as "well organized but limited theft and fraud on the part of certain employees" (Times of

Zambia,16, 18 August, 1998). On 18 August 1998, Times of Zambia carried a report involving the theft of K764m from a government ministry by a University of Zambia student in collaboration with an accountant at the Ministry of Finance.

Furthermore, at the Bank of Zambia, a fraud involving theft of K890m cash was reported in the Times of Zambia dated 29 August 1998. The matter which was in court at the time of the media report, involved five employees of the Bank of Zambia. According to discussions with some respondents, there has been a marked increase in bank frauds in recent years, and it would appear that the majority of bank failures witnessed in Zambia's banking industry since 1995, had been tinged with fraud. On 28 January 1997, the Times of Zambia carried a story that ten managers at the Credit Africa Bank (including five expatriates) had been fired on account of massive banking frauds.

By the end of 1997, Credit Africa Bank had foundered, its depositors left choking with anger, frustration, and sorrow. Its staff suffered the tragedy of unemployment. A greater concern is the fact that major frauds are perpetrated by management who are the same people charged with the responsibility of safeguarding enterprise assets and are expected to carry out their duties and responsibilities in an honorable manner and in the best interest of the organization for the benefit of all stakeholders. Left unchecked, the problem has the potential of not only damaging a business, but eroding the vestige of the confidence of the investing public in corporations, financial institutions, and other organizations, and hindering economic growth.

Through its independent reviews and evaluations of other controls, performance of management and compliance audits, internal audit can, if effectively administered, provide a very useful tool of control for checking fraud. It can, through compliance audits, act as an " ethics officer" for the organization, and can therefore adequately address management's fraudulent intentions. In revitalizing the Zambian economy, the existence of properly managed, efficient and commercially viable business concerns, can make significant contributions to the socio-economic development of the country. Successful firms are absolutely necessary for a healthy and productive economy as Kreitner rightly asserts. It is against this background that the role of the internal auditor and that of the governance system are considered crucial and a worthwhile study.

This research seeks to establish whether the existing regulation on organization is adequate, predominantly corporate governance. Once complete, this paper should give a clear picture of the status of corporation law and corporate governance in Zambia. This research establishes that the regulations on organizations have become obsolete and do not suffice for effective corporate governance. The research moves on to recommend the alteration of the Companies Act. The research suggests a constitutional declaration of directors' responsibilities as well as the preface of requirements on disclosure and transparency, especially financial reporting. It is essential that the law must be compatible with the manner in which the directors perform the affairs of companies, and is clear and easy to understand, consequentially promoting good corporate governance practices, and in hindsight, helping prevent the collapse of other corporate entities.

Literature Research and Review

A literature search was undertaken involving the scrutiny of published material from the DMI ST Eugene University Library and other sources.

Documents consulted and used in the study included the following: auditing books, professional manuals, and journals of the professional accountancy bodies which were scrutinized for relevant topics and articles to provide an understanding and some awareness of current thoughts on auditing matters relevant to the study. The review included various works by Professor N. J. Ronan related to corporate fraud, and the internal auditor and corporate governance; the King Report on Corporate Governance, the Hampel Committee Report, and the articles on the Cadbury Report and World bank publications to provide an appreciation of the concept of corporate governance and provide a benchmark against which to assess corporate governance structures in Zambia; management books including those specifically relating to Africa and Zambia were read to provide an insight into the social and economic environments and their influence vis-a-vis their search problem.

Other documents studied included: the Auditor General's reports for the financial year ended 31 December 1995 and 1996, and copies of the Times of Zambia which were perused for fraud cases reported during the period from January 1996 to September 1998.

Statement of Problem

The research problem is that of “corporate fraud”, often defined as a silent risk because of its stealth nature. Corporate fraud in a wider context is defined as the gaining of some material advantage by dishonest means by management or its employees (Ronan, Lwisi 1993:2). The purpose of the study is therefore to assess the financial magnitude of the problem of fraud, and to evaluate the effectiveness of both internal audit and corporate governance, in ensuring proper checks and balances to prevent or minimize fraud and malpractices; ensure sound leadership to enhance the long-term value of shareholders, and the financial viability of business entities.

Research Questions

Main Questions

a) Should companies have an internal auditing function?
b) What should an internal auditing function do?
c) What is the relationship between internal audit and the auditing committee?
d) How do you assess the effectiveness of the internal audit information?

Specific Questions

a) How are internal audit findings reported?
b) Does internal audit have sufficient funds?

Objectives of the Study

The research aims at the following objectives:

Main Objectives

1. To assess the effectiveness of the internal audit function as it is currently perceived and practiced in Zambia.
2. To assess the effectiveness and appropriateness of corporate governance arrangements within organizations in Zambia.

Specific Objectives

1. To explore and suggest more effective ways of enhancing internal audit as a check against corporate fraud.
2. To identify impediments to good corporate governance and foster the proper administration of effective corporate governance arrangements.
3. To assess the impact of such fraud on the Zambian economy, corporate behavior, and ethics of society.

Potential Benefits from the Study

The following are potential benefits expected from the study:

- Minimization of the risk of fraud and safeguarding of the organization's assets.
- Effective and efficient use of resources for the achievement of organizational goals.
- Proper management of organizations to enhance the long-term value for shareholders and the financial viability of the enterprise and prosperity.
- Enhancement of corporate social responsibility.

Role of the Internal Auditor

The job of an internal auditor can be a very interesting and stimulating job on the one hand, and an extremely difficult and thankless job on the other. Interesting and satisfying in that the scope of his work is much broader than that of the external auditor and his work is concerned to review all the arrangements that have been made to manage an entity. Given the relative autonomy and independence, the nature of his job provides endless challenges and satisfaction.

Extremely difficult in the sense that, because of the ever-present role conflict between the auditor's perception of his own role and the auditee's perception of the auditor's role, the auditor is normally treated in a negative and hostile way. His work is primarily concerned with the independent appraisal of the effectiveness of the internal control system. Unavoidably, "staff are key elements of any system of internal control" (Chambers, 1981:7) “and any report he issues, no matter how obliquely it’s put, refers to staff”.

Furthermore, the internal auditor, unlike the external auditor works closely with the same staff in the organization for long periods of time. Because of the nature of his work, which tends to place a moral check on management and employees and also act as a discouragement to wrongdoing, corrupt and dishonest management and employees tend to fear and hate the internal auditor and maybe extremely hostile and uncooperative as they perceive the auditor as a serious impediment to their divergent behavior.

Because of the role conflict, his presence is usually greeted with hostility and suspicion, "for instance the auditor may see himself as a constructive, welcome, friendly advisor; whereas the auditee may see him as a destructive, unwelcome, unfriendly snoop or policeman". (Chambers 1981:22). The people dimensional long with unfavorable images held by the auditor present hindrances that impact on the auditor's performance and his job satisfaction.

Research Methodology

The collection of both primary and secondary data will be achieved through the following procedures: questionnaires, interviews, observation, participation in seminars, and the study of documentary. Structured questionnaires comprising three sets each will be sent out to selected organizations for completion by internal auditors and chief executives/ directors respectively.

The use of structured questionnaires has been adopted for the following principal reasons:

- Convenience as this is the easiest and quickest method of collecting data.
- To minimize ambiguity in questions, it ensures accuracy in answers, and thus minimizes the response error.
- Facilitates the tabulation and analysis of data and avoids the collection of irrelevant information.

However, in instances where original answers and respondent’s opinions are sought, use of open-ended questions shall be observed. Primary data obtained through questionnaires will be used in the assessment of internal audit and corporate governance effectiveness and the examination of corporate fraud in Zambia. Secondary data gathered through the study of both primary and secondary documents will be used in cross-checking the prevalence of fraud and in drawing final conclusions on the extent of the fraud and seriousness of the problem of fraud in Zambia.

The study will involve the evaluation of a private sector company i.e. Oriental Quarries. The units of study will be persons occupying positions related to internal auditing and the chief executive officer, in this organization. The purposive sampling method will be used to select the companies included in the research sample population. This is a non-probability sampling method which involves the researcher's own judgment about which elements should be chosen to best meet the purpose of the study.

Listed companies, as strongly suggested by Cadbury, are expected to exhibit and practice high standards of corporate governance to ensure protection of the investing community's money, inspire confidence, and encourage further investment. A sample population of Oriental Quarries will be drawn by way of purposive sampling. The determination of the sample size is to a large extent influenced by time and money constraints. The sample frame established may constitute medium-sized to large organizations. The theory behind the basis of selection is that large and well-established organizations, due to their size, complexity of their operations, diverse locations, and large volumes of business, are more susceptible to fraud, and more likely to experience serious management problems as compared to smaller businesses.

This, however, should not be construed that higher standards of governance are only confined to medium-sized and large organizations. The fact is that higher standards of corporate governance are as important for smaller companies as they are for larger companies. Kreitner asserts that the "health of every nation's economy depends on how well its small businesses are managed".

Findings of the Study

At senior level, it was found that 5 respondents out of 23 representing 11% knew exactly what an internal auditor position entails while 7 middle management personnel also stated that they too know of an internal auditor position in a firm which represented a whopping 30% of staff. The low-level management had 8 respondents representing about 50% with 3 giving no response at 9%.

When asked on the apportionment of audit time (nature of work), senior management had 60% on internal control and 30% on investigative audits with 10% being spent on other businesses. Middle management spent 70% of its time on internal control and 20% on investigative audits with 10% on other businesses. Lower management spent 80% of its time on internal control and 15% on investigative audits with 5% on other businesses. This gave an average of 70 percent in total of time spent on internal control in Oriental Quarries, with a 22 percent average time spent on investigative audits and 8% on other businesses.

The Board meets at least once in a quarter to review inter-alia the quarterly financial results and other items on the agenda. Additional meetings are held as and when required. Facilities of video conferencing or other audio-visual means are also provided to enable the Directors to participate in Board meetings. During the year that ended on 31 March, 2015, the Board of Directors met six times, on 23 April, 2014, 23 July, 2014, 17 September, 2014, 21 October, 2014, 22 January, 2015, and 4 March, 2015. The maximum gap between any two meetings was not more than one hundred and twenty days.

Recommendations

The recommendations of the research study made to ameliorate the existing state of affairs are:

To ensure transparency and fairness, the appointment of members to the board should be the responsibility of the board as a whole. The board should have a balance of executive and non-executive directors. The non-executive directors who are expected to bring an independent judgment to bear on issues such as strategy, performance, key appointments, resources, and conflict of interest resolution, should be sufficient in number and should have access to management information if they have to be effective.

While the board should meet regularly and retain full and effective control over the company by closely monitoring and reviewing the performance of the executive management, the board should guard against being intimately involved in the day-to-day affairs of the company. The executive directors should however give day-to-day attention to the business. It should be a strict requirement that each person appointed to the board, if not a member, should seek membership with an institute of directors, in the case of listed and quoted companies and parastatal. Board members should ensure that they participate in professional development seminars to upskill themselves in financial and governance matters.

One of the major functions of the board of directors is to provide a special training for them in order to equip them with skills to understand the company's financial results and outside benchmarks. The establishment of an audit committee should be a strict requirement, particularly for every listed company. The audit committee should be made up of independent non-executive directors. This committee can be used as a vehicle for ensuring supervision and accountability at the board level.T o enhance their independence and objectivity, internal auditors must report to the audit committee. Furthermore, the internal auditor should have direct access to the chief executive and the board as whole. The internal auditor’s terms of reference should include the detection of fraud. In this era, fraud becomes one potential source of distortion of financial statements. The auditor must therefore consider the possibility of fraud in conducting his examination. In the case of failure to do so, the basic duty of lending credibility to the financial statements becomes nothing but a farce.

The auditor’s duties which essentially revolve around the expression of an opinion on the fairness of a firm's financial statements, must be revised. Both internal and external auditors, should upon establishing that a fraud has been committed, report directly to the audit committee/ the police fraud squad. Suspected fraud should also be quickly reported. The board of directors should see to it that their companies develop, publish, and enforce a strong code of ethics. Ethics training should be introduced in all college and university programs. It is pleasing to note that the University of Zambia introduced ethics training in May, 1998.

With reference to fraud, the practice of whistleblowing which involves reporting perceived unethical organizational practices to outside authorities should be encouraged. The board should ensure that adequate internal controls are put in place to minimize the risk of fraud and malpractices and thus safeguard the organization's assets. Employees should be adequately rewarded financially. The government should revamp the ACC/DEC investigations' function by offering specialist training in fraud investigations and employing personnel with forensic accounting and legal skills who should be well remunerated.

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